

# ***Tax Issues Arising from Inbound Investments into US REITs Meeting***

*Thursday, April 2<sup>nd</sup>*

*9:30am – 10:45am*

*JW Marriot Desert Ridge Resort & Spa  
Phoenix, AZ*

## **Moderator:**

A. Cristina Arumi, Partner, Ernst & Young

## **Panelists:**

James Croker, Partner, Alston & Bird LLP

Ameek Ponda, Partner & Director-Tax Department

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**DESCRIPTION OF THE CHAIRMAN'S MARK  
OF PROPOSALS RELATING TO REAL ESTATE INVESTMENT TRUSTS  
(REITs), REGULATED INVESTMENT COMPANIES (RICs) AND THE  
FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT (FIRPTA)**

Scheduled for Markup  
by the  
SENATE COMMITTEE ON FINANCE  
on February 11, 2015

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



February 9, 2015  
JCX-30-15

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## INTRODUCTION

The Senate Committee on Finance has scheduled a committee markup on February 11, 2015, of proposals relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA). This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the proposals.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of Proposals Relating to the Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA)* (JCX-30-15), February 9, 2015. This document can also be found on the Joint Committee on Taxation website at [www.jct.gov](http://www.jct.gov).

**A. Proposals Relating to Real Estate Investment Trusts (REITs),  
Regulated Investment Companies (RICs), and  
the Foreign Investment in Real Property Tax Act (FIRPTA)**

**Present Law**

**General rules relating to FIRPTA**

A foreign person that is not engaged in the conduct of a trade or business in the United States (and is not an individual who is present in the U.S. at least 183 days in the year) generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or of other capital assets.<sup>2</sup>

However, the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”)<sup>3</sup> generally treats a foreign person’s gain or loss from the disposition of a U.S. real property interest (“USRPI”) as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.<sup>4</sup> In the case of a foreign corporation, the gain from the disposition or distribution of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payer of amounts that FIRPTA treats as effectively connected with a U.S. trade or business (“FIRPTA income”) to a foreign person generally is required to withhold U.S. tax from the payment. Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on

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<sup>2</sup> Secs. 871(b), 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale (sec. 864(c)(7)). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>3</sup> Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

<sup>4</sup> Sec. 897(a). In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

any sale of stock that is regularly traded on an established securities market),<sup>5</sup> and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation during the applicable testing period.<sup>6</sup> The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USPRI from an entity such as a partnership, real estate investment trust (“REIT”) or regulated investment company (“RIC”).<sup>7</sup> The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person’s total U.S. effectively connected income and deductions (if any) for the taxable year.

#### U.S. real property holding corporations and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a domestic U.S. real property holding corporation (“USRPHC”), generally defined as any corporation, unless the taxpayer establishes that the fair market value of the corporation’s USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business, at all times during a “testing period,” which is the shorter of the duration of the taxpayer’s ownership of the stock since June 18, 1980, or the five-year period ending on the date of disposition of the stock.<sup>8</sup>

Under an exception, even if a corporation were a USRPHC, a shareholder’s shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the seller shareholder held (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.<sup>9</sup> Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.<sup>10</sup> The attribution rules also attribute

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<sup>5</sup> Sec. 1445(b). Other excepted circumstances include the sale of a personal residence where the amount realized does not exceed \$300,000.

<sup>6</sup> Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See Sec. 1445(e)(4) and 1445(e)(5).

<sup>7</sup> Sec. 1445 and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

<sup>8</sup> Secs. 897(c)(1)(A)(ii) and 897(c)(2).

<sup>9</sup> Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

<sup>10</sup> If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. (Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C)). Also, if five percent or more in value of the stock in a

stock ownership between spouses and between children, grandchildren, parents, and grandparents.

“Cleansing rule” exception where corporate gain recognized

An interest in a corporation is not a USRPI if, as of the date of disposition of such interest, such corporation did not hold any USRPIs and all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations.<sup>11</sup>

**FIRPTA rules for foreign investment through REITS and RICs**

Special FIRPTA rules apply to foreign investment through a “qualified investment entity”, which includes any real estate investment trust (“REIT”). Prior to January 1, 2015, the term also included certain regulated investment companies (“RICs”) that invest largely in U.S. real property interests (including stock of one or more REITs). On and after that date, such RICs are treated as qualified investment entities under FIRPTA only for the purpose of applying FIRPTA to certain distributions the RIC receives or makes that are attributable to its interest in a REIT.<sup>12</sup>

REITs and RICs must satisfy a number of requirements, and are generally taxable as U.S. domestic corporations, but are subject to a modified corporate tax regime that permits the corporation to deduct amounts distributed to shareholders. The shareholders generally include such distributions in income.

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is “domestically controlled” (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period<sup>13</sup>), stock of such entity is not a USRPI and a

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corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. (Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C)).

<sup>11</sup> Sec. 897(c)(1)(B).

<sup>12</sup> Sec. 897(h)(4)(A)(ii). The provision that expired after December 31, 2014, more generally treating such RICs as qualified investment entities, has expired previously but has subsequently been reinstated through December 31, 2014.

<sup>13</sup> The testing period for this purpose is the shorter of i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, ii) the five-year period ending on the date of the

foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC.<sup>14</sup> Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the “person who is required to include in his return the dividends received on the stock.”<sup>15</sup> The IRS has issued a private letter ruling concluding that the term “directly or indirectly” for this purpose did not look through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes “and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity.”<sup>16</sup>

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPI's, except for distributions to certain five-percent or smaller shareholders

Code section 897(h) provides that a distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.<sup>17</sup> The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of U.S. REITs or RICs.<sup>18</sup> An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to both nonliquidating and liquidating distributions, and to distributions treated as sales or exchanges of stock by the investor as well as to dividend distributions) and that the IRS will issue regulations to that effect.<sup>19</sup>

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disposition or distribution, as the case may be, or iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

<sup>14</sup> As noted previously, after December 31, 2014, a RIC is not included in the definition of a qualified investment entity for purposes of this rule permitting stock of a “domestically controlled” qualified investment entity to be sold without FIRPTA tax. Sec. 897(h)(4)(A)(ii).

<sup>15</sup> Treas. Reg. Sec. 1.897-1(c)(2)(i) and Treas. Reg. Sec. 1.857-8(b).

<sup>16</sup> PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

<sup>17</sup> Sec. 897(h)(1).

<sup>18</sup> In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

<sup>19</sup> Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of U.S. real property interests are not exempt



Code section 897(h)(1) provides an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located within the U.S., during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.<sup>20</sup> Such distributions that are dividends are treated as dividends from the qualified investment entity,<sup>21</sup> and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are not dividends are not subject to tax under FIRPTA.<sup>22</sup>

### **FIRPTA withholding and reporting of information regarding USRPHC status**

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.<sup>23</sup> The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.<sup>24</sup> Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).<sup>25</sup>

Treasury regulations<sup>26</sup> generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform

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from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

<sup>20</sup> Sec. 897(h)(1), second sentence. As noted previously, after December 31, 2014, a RIC is not a qualified investment entity for this purpose.

<sup>21</sup> Secs. 852(b)(3)(E) and 857(b)(3)(F).

<sup>22</sup> AM 2008-003, February 15, 2008.

<sup>23</sup> Sec. 1445.

<sup>24</sup> Sec. 1445(b)(6).

<sup>25</sup> Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

<sup>26</sup> Treas. Reg. Sec. 1.897-2(h).

that person whether the interest constitutes a USRPI.<sup>27</sup> No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT, nor to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.<sup>28</sup>

### **General Code authorization of certain returns by foreign persons**

Present law section 6039C provides for returns by foreign persons holding direct investments in U.S. real property interests for the calendar year, to the extent provided by regulations. No regulations have been issued under this section.

### **Corporate dividends-received deduction for certain U.S. source dividends received from foreign corporations**

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.<sup>29</sup>

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<sup>27</sup> As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation (“USRPHC”). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation’s U.S. real property interests do not amount to the relevant 50 percent or more of the corporation’s relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

<sup>28</sup> Treas. Reg. sec. 1.897-2(h)(3).

<sup>29</sup> Sec. 243.

Dividends from REITs are not eligible for the corporate dividends received deduction.<sup>30</sup> Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.<sup>31</sup>

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.<sup>32</sup> A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned RIC.<sup>33</sup> Treasury regulations section 1.246-1 states that the deductions provided in sections “243... 244... and 245 (relating to dividends received from certain foreign corporations)” are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

### **Description of Proposals**

#### **1. Publicly traded REITs and certain publicly traded qualified shareholder entities that hold REIT stock**

In the case of REIT stock only, the proposal increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The proposal likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of U.S. real property interests, as a dividend, rather than as FIPRTA gain. Any distributions to such 10 percent (or less)

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<sup>30</sup> Secs. 243(d)(3) and 857(c)(1).

<sup>31</sup> Secs. 243(d)(2) and 854(b)(1)(A) and (C).

<sup>32</sup> Sec. 245.

<sup>33</sup> IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its “CFC” status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.

shareholders that are not dividends (for example, if the qualified investment entity surrendered its stock in a redemption that was not treated as a dividend) would be exempt from U.S. tax.<sup>34</sup>

For these purposes, the attribution rules of section 897(c)(6)(C) are modified to refer to the determination of whether a person holds more than 5 percent of a class of stock that is publicly traded (in the case of a non-REIT shareholder) or more than 10 percent (in the case of a REIT shareholder), as applicable. In either case, however, the proposal retains the present law attribution rules of section 897(c)(6)(C) that trigger attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation.

The proposal also provides that REIT stock held by a qualified shareholder is not a U.S. real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as that “more than 10 percent” rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA. Also, the REIT may sell its assets and distribute the proceeds in a transaction that is treated as a sale of the qualified shareholder’s REIT stock, without the application of FIRPTA. If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) does hold more than 10 percent of such class of REIT stock, then a percentage of the REIT stock held by the qualified shareholder equal to such investor's percentage ownership of the qualified shareholder is treated as a US real property interest in the hands of the qualified shareholder and is subject to FIRPTA.<sup>35</sup>

A qualified shareholder is defined as an entity that is (i) eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program, (ii) a qualified collective investment vehicle (as defined below), (iii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and (iv) that maintains records on the identity of each person who, at any time during the qualified shareholder’s taxable year, is the direct owner of more than 10 percent of that principal class of interests.

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<sup>34</sup> This result would follow from application of the conclusion of AM 2008-83, Feb. 15, 2008. See Present Law, FIRPTA rules for foreign investment through REITs and RICs, *supra*.

<sup>35</sup> As one example, if an individual shareholder owns 10 percent of a REIT’s stock directly and also owns 10 percent of the stock of a qualified shareholder that in turn owns 80 percent of that REIT’s stock (thus indirectly owning another 8 percent of such REIT’s stock), such shareholder is deemed to own more than 10 percent (*i.e.*, 18 percent) of that REIT’s stock under the proposal. Accordingly, 10 percent (the investor's percentage ownership of the qualified shareholder) of the REIT stock held by the qualified shareholder is treated as a U.S. real property interest.

A qualified collective investment vehicle is defined as an entity that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT<sup>36</sup> (ii) would be classified as a U.S. real property holding corporation (determined without regard to the proposal's rules that exempt REIT stock held by the entity from treatment as a U.S. real property interest), or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

### **Effective Date**

The disposition provisions of the proposal apply to dispositions on and after the date of enactment. The attribution rule change (to refer to the separate 5 percent and 10 percent limitations) is effective on the date of enactment. The distribution provisions apply to any distribution by a REIT on or after the date of enactment which is treated as a deduction for a taxable year of such REIT ending after such date.

## **2. Domestically controlled definition**

For purposes of determining whether a qualified investment entity is domestically controlled, the proposal provides a number of new rules and presumptions.

First, a qualified investment entity shall be permitted to presume that stock held by a holder of less than five percent of a class of stock regularly traded on an established securities market in the United States is held by U.S. persons throughout the testing period except to the extent that the qualified investment entity has actual knowledge regarding stock ownership. Second, any stock in the qualified investment held by another qualified investment entity (I) any class of stock of which is regularly traded on an established stock exchange, or (II) which is a regulated investment company which issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined applying the permitted foregoing presumptions) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

### **Effective Date**

The proposal is effective on the date of enactment.

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<sup>36</sup> For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

### **3. Increase 10 percent FIRPTA withholding to 15 percent**

The proposal generally increases the rate of withholding of tax on dispositions and certain distributions of URSPs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed \$1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed \$300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed \$1,000,000.

#### **Effective Date**

The proposal applies to dispositions after the date which is 60 days after the date of the enactment.

### **4. Required notification of FIRPTA status as a USRPHC, presumption of foreign control of qualified investment entities, and penalty for failure to disclose FIRPTA status**

The proposal requires disclosures of USRPHC status, by any corporation that is or was a U.S. real property holding corporation at any time during the five-year period ending on the date on which disclosure is made. Such a corporation must attach a statement regarding its status as a USRPHC within the past five years to its annual tax return, filed on or before the due date (including extensions). Such a corporation is also required to disclose such status on Form 1099s sent to shareholders, in annual reports, on websites, and, in the case of privately-held corporations, on stock certificates.

In the absence of disclosure to the contrary (in such form and manner as the Secretary of the Treasury may prescribe), any qualified investment entity (as defined in section 897(h)(4)) will be presumed for purposes of section 897 to be foreign controlled. Thus, if a foreign person disposes of the stock of a qualified investment entity that is domestically controlled under the rules provided in the proposal, but that does not disclose its domestically controlled status, the disposition is treated as one of stock of an entity that is not domestically controlled, and hence FIRPTA would generally apply to the disposition unless another exception applied.

A penalty is imposed for failure to comply with the USRPHC notification requirements. In the case of a corporation with gross receipts of less than \$5,000,000, the penalty is \$500,000. The penalty increases to \$1,500,000 for corporations with gross receipts of \$5,000,000 or more. In the case of a corporation that holds U.S. real property interests with a gross fair market value of \$1 billion or more, the penalty is \$5 million, increased to \$10 million in the case of intentional failure to disclose or report. For purposes of determining gross receipts and gross fair market value under these penalty provisions, related-party aggregation rules apply.

Under regulations prescribed by the Secretary of the Treasury, publicly traded partnerships shall also be subject to these rules.

#### **Effective Date**

The proposal takes effect on January 1, 2016.

## **5. Require FIRPTA withholding by brokers**

The proposal amends the FIRPTA withholding rules to provide that in the case of any disposition of stock of a USRPHC involving a broker (as defined in section 6045(c)), such broker shall be required to deduct and withhold a tax equal to 15 percent of the amount realized on the disposition. Certain exceptions apply.

Broker withholding is not required for sales of stock of a domestically controlled qualified investment entity (as defined in section 897(c)(4)) or for stock of a REIT that is not treated as a U.S. real property interest because it is being sold by an entity that is a qualified shareholder under the proposal. With respect to any disposition of any class of stock of a USRPHC which is regularly traded on an established securities market, broker withholding is not required if the transferor, immediately prior to the disposition, holds five percent or less of such class of stock (10 percent or less in the case of REIT stock). For that purpose, brokers are permitted to rely on public statements made by public companies, including statements related to the status of the company as a U.S. real property holding corporation or as a domestically controlled qualified investment entity.<sup>37</sup>

Broker withholding is only required if the broker had actual knowledge (or reasonably should have known) that the disposition was of stock of a U.S. real property holding corporation.

The proposal amends the Code provision that currently exempts from withholding the disposition of a share of a class of stock that is regularly traded on an established securities market, to require the broker withholding in accordance with the foregoing provisions.

Under regulations prescribed by the Secretary of the Treasury, similar withholding rules shall apply to brokers in the case of a disposition of a publicly traded partnership interest where such partnership would be a U.S. real property holding corporation if it were a U.S. corporation.

### **Effective Date**

The proposal applies to dispositions after December 31, 2015.

## **6. Cleansing rule not applicable to RICs or REITs**

Under the proposal, the so-called “cleansing rule” applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

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<sup>37</sup> Under the immediately preceding proposal, any qualified investment entity (as defined in section 897(h)(4)) is presumed for FIPTRA purposes to be foreign controlled unless the entity has made a disclosure to the contrary in such form and manner as the Secretary of the Treasury may prescribe.

### **Effective Date**

The proposal applies to dispositions after the date of enactment.

### **7. Dividends derived from RICs and REITs ineligible for deduction for U.S. source portion of dividends from certain foreign corporations**

Under the proposal, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245 of the Code, dividends from RICs and REITs are not treated as dividends from domestic corporations.

### **Effective Date**

The proposal applies to dividends received from RICs and REITs on or after the date of enactment.



## B. Estimated Revenue Effects

Fiscal Years [Millions of Dollars]												
<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2015-20</u>	<u>2015-25</u>
-9	-7	-6	-5	-9	-4	1	1	[1]	1	[2]	-41	-38

[1] Gain of less than \$500,000.

[2] Loss of less than \$500,000.

## **C. Increase Continuous Levy Authority on Payments to Medicare Providers and Suppliers**

### **Present Law**

#### **In general**

Levy is the administrative authority of the IRS to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.<sup>38</sup> Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,<sup>39</sup> the property is not exempt from levy,<sup>40</sup> and the IRS has provided both notice of intention to levy<sup>41</sup> and notice of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")<sup>42</sup> at least 30 days before the levy is made. A levy on salary or wages generally is continuously in effect until released.<sup>43</sup> A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.<sup>44</sup>

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.<sup>45</sup>

The CDP notice (and pre-levy CDP hearing) is not required if: (1) the Secretary finds that collection would be jeopardized by delay; (2) the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund; (3) the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served; or (4) the Secretary has served a Federal contractor levy. In each of these four cases,

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<sup>38</sup> Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

<sup>39</sup> *Ibid.*

<sup>40</sup> Sec. 6334.

<sup>41</sup> Sec. 6331(d).

<sup>42</sup> Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

<sup>43</sup> Secs. 6331(e) and 6343.

<sup>44</sup> Sec. 6321.

<sup>45</sup> Secs. 6331(d)(3) and 6861.

however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.<sup>46</sup>

### **Federal payment levy program**

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997<sup>47</sup> authorized the establishment of the Federal Payment Levy Program (“FPLP”), which allows the IRS to continuously levy up to 15 percent of certain “specified payments” by the Federal government if the payees are delinquent on their tax obligations. With respect to payments to vendors of goods, services, or property sold or leased to the Federal government, the continuous levy may be up to 100 percent of each payment.<sup>48</sup> For payments to Medicare providers and suppliers, the levy is up to 15 percent for payments made within 180 days after December 19, 2014. For payments made after that date, the levy is up to 30 percent.<sup>49</sup>

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by Treasury’s Bureau of Fiscal Service (“BFS”), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct BFS to levy the taxpayer’s Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

### **Description of Proposal**

The proposal provides that the present limitation of 30 percent of certain specified payments be increased by an amount sufficient to offset the estimated revenue loss of the provisions described in Part A, above.

### **Effective Date**

The proposal is effective for payments made after 180 days after the date of enactment.

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<sup>46</sup> Sec. 6330(f).

<sup>47</sup> Pub. L. No. 105-34.

<sup>48</sup> Sec. 6331(h)(3).

<sup>49</sup> Pub. L. No. 113-295, Division B.



**Wise** March 31 - April 2  
**2015**



**NAREIT's Law, Accounting  
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JW Marriott Desert Ridge Resort & Spa  
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## Tax Issues Arising From Inbound Investment Into US REITs

**Cristina Arumi  
Jim Croker  
Rohn Grazer  
Ameek Ponda**

**(a/k/a FIRPTA, FIRPTA, FIRPTA)**

**March 31-April 2, 2015**

# Overview of Topics

- ◆ Overview of US Taxation of Non-US Investors in US REITs
  - ◆ Legislative Proposals
- ◆ Domestically Controlled REITs
- ◆ REIT Joint Ventures
  - ◆ Preparing for the Exit Strategy
  - ◆ Understanding the Unique Tax Rules for Foreign Governments
- ◆ Capital Gain Dividends and other Section 897(h)(1) Distributions
  - ◆ Substantive Tax
  - ◆ Withholding Obligations
- ◆ Other FIRPTA/Inbound Issues
  - ◆ What is a USRPI?
  - ◆ Fund/Alternative Investment Vehicle (“AIV”) Investments

# **Overview of US Taxation of Non-US Investors in US REITs**

# Taxation of Non-US Persons



◆ Is the US-source income effectively connected with a US trade or business (“ECI”)?

◆ If Yes:

◆ Subject to US tax at regular rates

◆ Corporations taxed at a maximum of 35% under current law on ordinary income and capital gains

◆ Individuals taxed at a maximum of 39.6% on ordinary income and 20% on capital gains (25% on depreciation recapture)

◆ Additional 30% branch profits tax imposed on non-US corporations, subject to exemption or reduction under an applicable tax treaty

◆ Tax return filing obligations

◆ US tax may be creditable against foreign tax obligations

# Taxation of Non-US Persons

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## ◆ Is the US-source income effectively connected with a US trade or business?

### ◆ If No:

- ◆ US-source fixed or determinable annual or periodical income (i.e., dividends, interest, certain rents)
  - ◆ 30% US withholding tax on gross basis, but subject to exemption or reduction under applicable income tax treaties
- ◆ Most capital gains
  - ◆ Generally not taxable
- ◆ Generally no US tax return filing obligation

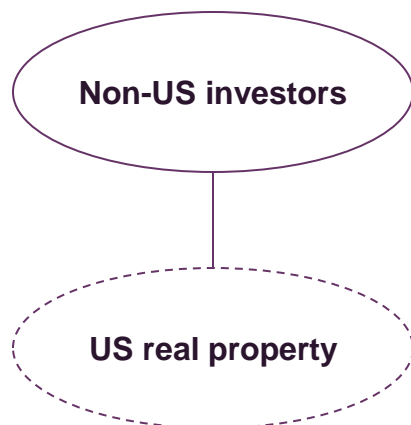


# Taxation of Non-US Persons – US Real Estate



- ◆ Real estate rental income generally ECI (unless net lease)
- ◆ Gain from disposition of a US real property interest (“**USRPI**”) is ECI and subject to withholding, US tax and tax return filing obligations under FIRPTA
- ◆ USRPI includes US real estate and stock of a US corporation if the fair market value of such corporation’s US real property interests is at least 50% of the value of most of its assets (“**USRPHC**”)
  - ◆ Exception for sale of stock in domestically controlled REITs
  - ◆ Exception for sale of certain small interests in listed USRPHCs

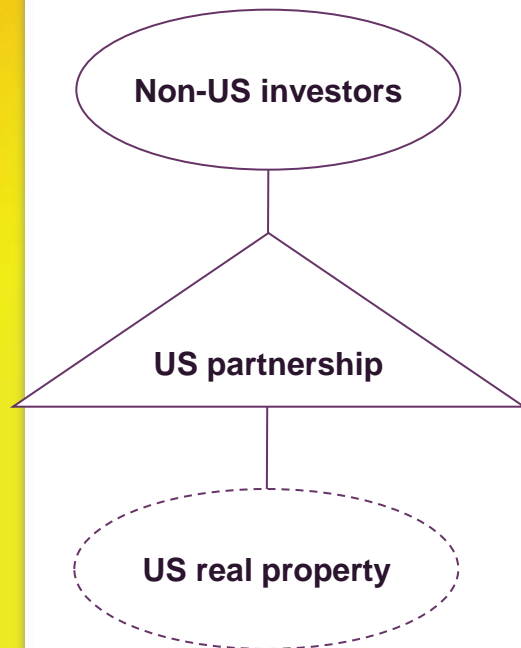
# Direct Investment



- ECI rules probably apply to all income (unless net lease property).
- Non-US investors must file US tax returns.
- Corporate foreign investors:
  - (a) Maximum 35% federal tax (under current law) on ordinary income and capital gains; state taxes also generally apply.
  - (b) Additional 30% US “branch profits tax” payment obligation for foreign corporate investors, which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%. May be reduced by applicable tax treaty and certain exceptions may apply.
- Individual foreign investors:
  - (a) Maximum 39.6% federal tax on ordinary income.
  - (b) Long-term capital gains eligible for 20%, or 25% in the case of unrecaptured section 1250 gain.
  - (c) US real property subject to US estate tax.

# Investment Through Partnership

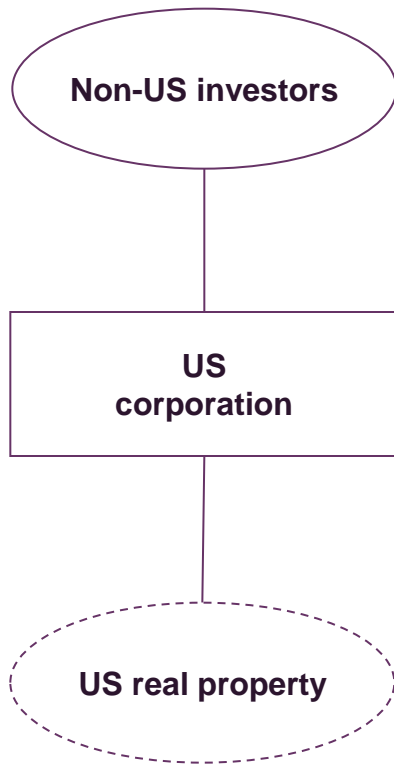
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- Partnership income flows through to investors. Non-US investors will likely be treated as engaged in a US business as a result of directly investing in the US partnership, which engages in US business (unless net lease property). Thus, essentially same consequences as direct investment.
- Allocable shares of operating income and gains from the sale of real estate subject to US tax at regular rates.
- Non-US investors must file US tax returns. State taxes generally apply.
- The Partnership must withhold quarterly on net ECI allocable to non-US partners at highest applicable rates under section 1446 and the regulations thereunder.
- Additional 30% US “branch profits tax” payment obligation for foreign corporate investors (unless reduced by treaty or exceptions apply), which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%
- Potential US estate tax consequences.
- Sale of interest in the US partnership
  - Gain on sale (capital gain) likely treated as ECI and taxable to investors at regular individual or corporate rates, as applicable. See IRC § 897(g); Rev. Rul. 91-32.
  - Seller withholding obligations – see IRC § 1445(e)(5); Treas. Reg. § 1.1445-11T(b).

# Investment Through US Corporation

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- US corporation pays tax at regular rates on operating income and gains from sale.
- Dividends subject to 30% US withholding tax (subject to treaty reduction). No filing obligation on dividends.
- Return of capital distributions subject to 10% FIRPTA withholding in absence of applicable exception.
- Gain on sale of US corporation stock taxable under FIRPTA and subject to 10% withholding in absence of applicable exception.
- No branch profits tax for foreign corporate investor.
- Could capitalize US corporation with debt payable to shareholders in order to offset income with interest deductions. (Limitations under section 163(j) if debt-equity ratio exceeds 1.5-to-1. Also, limits in certain cases if rate is too high or interest is accruing but unpaid.)
- Interest payments may be exempt as "portfolio interest" if lending shareholders do not own more than 10% of stock. Otherwise, 30% US withholding tax applies to interest payments, subject to treaty reduction.
- US corporation stock subject to US estate tax, subject to treaty exemption.

# U.S. Taxation of Non-U.S. Shareholders of U.S. REITs

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	Listed (Equity) REIT	Nonlisted (Equity) REIT	Mortgage REIT
Ordinary Dividends	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate
C/G Dividends			
$\leq 5\%$ S/Hs	30% withholding, subject to applicable treaty rate	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
$> 5\%$ S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
Gain on Sale of Shares			
$\leq 5\%$ S/Hs	Exempt	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
$> 5\%$ S/Hs	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
Liquidating Distributions			
$\leq 5\%$ S/Hs	Exempt	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
$> 5\%$ S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI

# Treaty Rates for Ordinary REIT Dividends

## ◆ US Model Treaty

- ◆ 0% for pension funds that do not own more than 10% of the REIT
- ◆ 15% for individuals who do not own more than 10% of the REIT
- ◆ 15% for persons who do not own more than 5% of any class of the REIT's listed stock
- ◆ 15% for  $\leq 10\%$  shareholders if the REIT is diversified, i.e., if no REIT property is worth more than 10% of the value of its total real property interests.

## ◆ Exemption for pension funds in certain (e.g., Canadian, Dutch, UK) treaties

- ◆ Limitations, e.g., exemption inapplicable to dividends received by Canadian pension plan from "related" REIT or by Dutch pension plan that owns more than 80% of any class of the REIT's stock

## ◆ Idiosyncratic treaty rates – 10% dividend rate under US treaties with Japan and China

# Taxation of Capital Gain Dividends

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- ◆ Distributions that are attributable to gain from sale of USRPIs are treated as FIRPTA gain – subject to recharacterization rule for  $\leq 5\%$  shareholders (one-year look-back period) of publicly traded REITs. IRC §§ 897(h)(1) & 857(b)(3)(F).
- ◆ Treat as C/G dividends the maximum amount that could have been treated as a C/G dividend. Treas. Reg. § 1.1445-8(c)(2)(ii)(A).
- ◆ Retention of FIRPTA treatment for distributions through tiered REITs. IRC § 897(h)(1).
- ◆ Wash sale anti-abuse rule. IRC § 897(h)(5).
- ◆ 35% withholding. IRC § 1445(e)(6).
- ◆ Because “net capital gain” not determinable until end of year, can withhold in subsequent year. Treas. Reg. § 1.1445-8(c)(2)(ii)(C).

# Legislative Proposals Affecting Taxation of Non-US Investors in US REITs



## ◆ Obama Budget Proposal

- ◆ Would exempt foreign pension funds from FIRPTA.

## ◆ Senate Finance Committee Proposals

- ◆ C/G dividends of publicly traded REITs would be recharacterized as ordinary dividends for  $\leq 10\%$  shareholders.
- ◆ Gain on sale of shares of publicly traded REIT by  $\leq 10\%$  shareholders would not be taxable under FIRPTA.
- ◆ FIRPTA would be inapplicable with respect to holdings in REITs (whether private or publicly traded) by certain listed Dutch beliggingsinstellings and listed Australian property trusts except with respect to investors therein that indirectly own more than 10% of the REIT's stock.
- ◆ 15% withholding rate on sales of USRPHC stock.
- ◆ Cleansed USRPHC rule would be inapplicable to REITs and RICs.



# Domestically Controlled REITs

# Benefit of Domestically Controlled REIT

- ◆ Section 897(h)(2) provides that stock in a “domestically controlled qualified investment entity” is not a USRPI
  - ◆ Therefore, a foreign person can sell stock in a domestically controlled REIT without a FIRPTA tax liability or FIRPTA withholding
  - ◆ But domestically controlled REIT status *does not* confer any FIRPTA exemption on capital gain dividends or other distributions from a REIT that are captured by section 897(h)(1)

# Definition of Domestically Controlled REIT

## ◆ Section 897(h)(4)(B)

- ◆ The term “domestically controlled qualified investment entity” means any qualified investment entity [REIT] in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.
- ◆ Generally, the testing period is the five-year period ending on the date of disposition or, if shorter, the period during which the REIT was in existence.
  - ◆ USRPHC that makes REIT election after first USRPHC year?
- ◆ Charter restrictions to maintain domestically controlled REIT status will not violate transferable share requirement. See, e.g., PLR 9630016.

# Domestically Controlled REIT Status

- ◆ What indirect ownership is/should be taken into account?
  - ◆ Actual owners of shares, i.e., persons required to include dividends in income to be taken into account. Treas. Reg. § 1.897-1(c)(2)(i).
  - ◆ No clear authority on whether to look through US partnerships, US C corporations, or US REITs, or whether base erosion could be relevant.
  - ◆ In PLR 200923001, the IRS concluded that it would not look through US C corporations, noting that they were not a REIT, RIC, hybrid entity, conduit, disregarded entity or other flow-through or look-through entity.
  - ◆ Publicly traded REIT disclosures regarding domestically controlled status versus practical impossibility to confirm domestically controlled status.
  - ◆ Process for establishing domestically controlled status for withholding agents uncertain. See Treas. Reg. §§ 1.897-2(g)(3) & (h)(3).

# Legislative Proposals to Clarify Domestically Controlled Determination

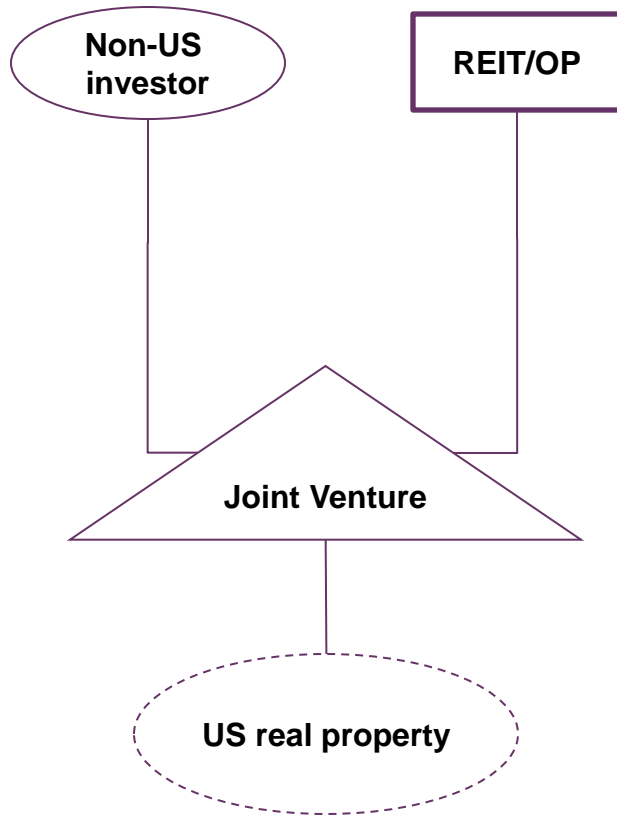
## ◆ Senate Finance Proposals

- ◆ Presumption that less than 5% shareholders of publicly traded REITs are US persons, absent actual knowledge to the contrary.
- ◆ Stock held by a publicly traded REIT or an open-end RIC is treated as held by foreign persons unless the shareholder REIT or RIC is itself domestically controlled, in which case it would be treated as a US person. Look-through for other shareholder REITs and RICs.
- ◆ Treated as not domestically controlled unless publicly disclose domestically controlled status.

# **Structures for JV Between REIT and Non-US Investor**

# Simple JV with Non-US Investor

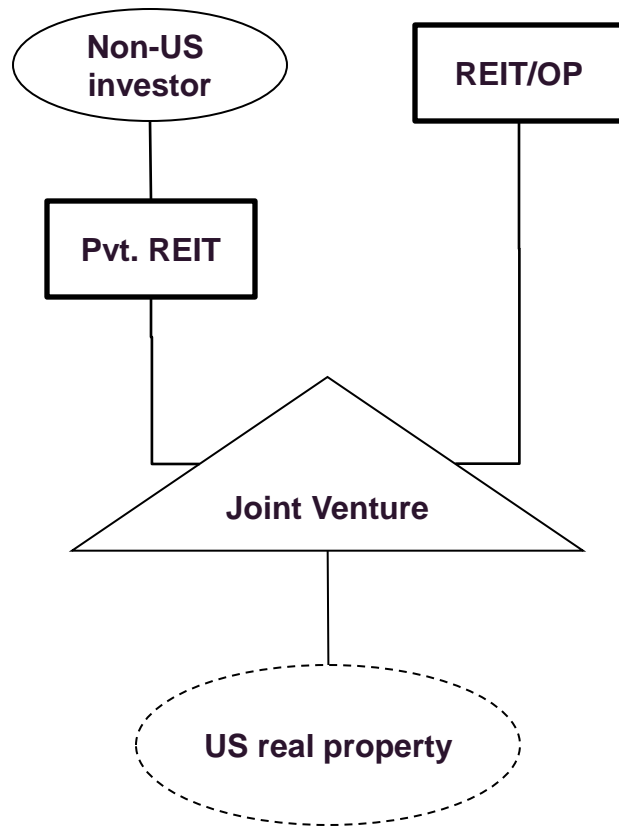
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- Basic Consequences
  - Operating income taxable.
  - Gain on sale of property or JV interest taxable
- Foreign Government investor – generally section 892 is not helpful
- Issues associated with property contribution by non-US investor? Nonrecognition transactions under FIRPTA

# Non-US Investor Invests Through REIT

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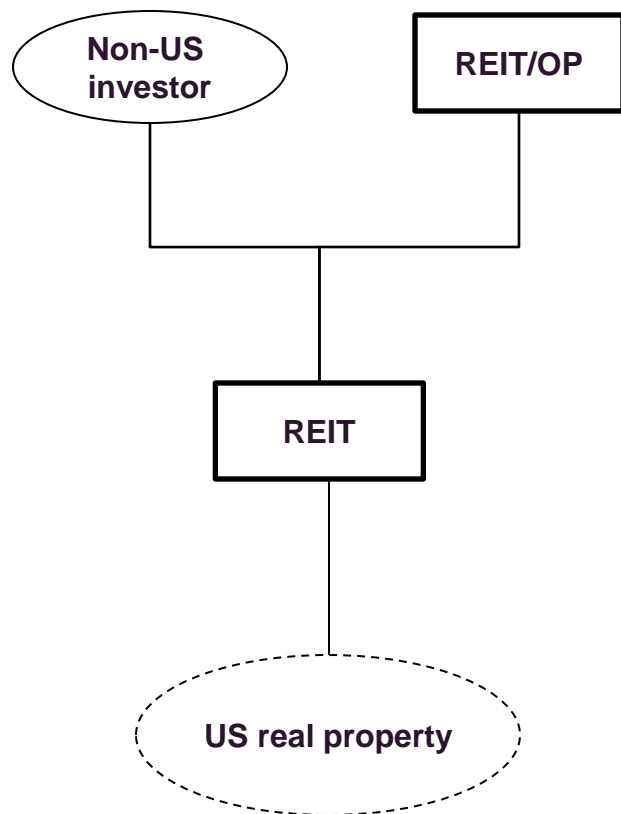


- Dividends taxable
- Lower withholding rates for interest may favor leveraged REIT
- Gains from JV sales of USRPIs taxable under section 897(h)(1)
- Stock sale gain taxable (foreign-controlled REIT)
- Liquidating distributions taxable
- Other Issues
- Foreign Government
  - REIT is controlled commercial entity so section 892 not helpful



# Non-US Investor and REIT Form Jointly Owned Private REIT

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- Ordinary dividends taxable
- Distributions attributable to gains from property sales taxable
- Stock sale gain – No tax if REIT is domestically controlled
- Foreign Government Investors
  - Ordinary dividends exempt unless recipient or REIT is a controlled commercial entity
  - Distributions attributable to gains from property sales taxable
  - Stock sale gain exempt (but if seller or REIT is a controlled commercial entity, and if REIT is foreign controlled, then taxable)

## Tax-related Deal Issues for Joint Ventures Between US and Non-US Investors

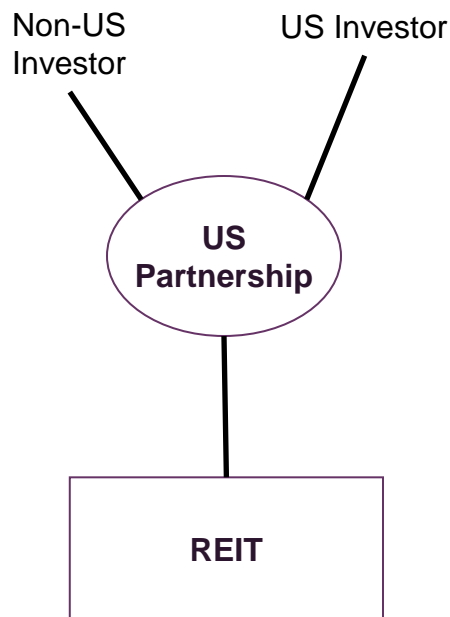
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# Single-Property Domestically Controlled REIT

- ◆ Exemptions for ordinary dividends for foreign pension funds under tax treaties and for foreign governments under section 892, combined with exemption for gain on sale of shares of domestically controlled REITs, led to widespread use of single-property domestically controlled REITs.
- ◆ Uncertainty whether liquidation distributions should be treated as section 897(h)(1) distributions of FIRPTA gains or as section 331 distributions in exchange for stock of a domestically controlled REIT.
  - ◆ PLR 9016021: liquidating distributions treated as section 331 distributions in exchange for stock (not a domestically controlled REIT, but section 331 treatment allowed shareholders to recover outside basis).
  - ◆ PLR 200453008: revoked PLR 9016021.
  - ◆ Notice 2007-55: liquidating distributions treated as section 897(h)(1) distributions of FIRPTA gain (and is taxable notwithstanding Section 892).
  - ◆ AM 2008-003: liquidating distributions to  $\leq 5\%$  shareholder of publicly traded REIT not recharacterized as ordinary dividends.

# US Partnership to Hold Domestically Controlled REIT

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- ❖ No FIRPTA withholding with US seller, whereas reliance on domestically controlled REIT status less certain.
- ❖ Partnership agreement addresses business deal regarding maintaining domestically controlled REIT status, exit structure, etc.
  - ❖ Could partnership provisions implicate REIT rules, e.g., transferable share requirement, preferential dividend rules, etc.?

## Deal Issues – Non-US Investor/Seller

- ◆ Sale of REIT shares (or partnership owning REIT shares) is optimal exit strategy for non-US partner.
- ◆ Coordinated sale of entire REIT so buyer can liquidate and get a step-up (and pay higher price) preferred.
- ◆ Maintenance of domestically controlled REIT status.
  - ◆ US partner cannot sell its interest in REIT shares (or partnership owning REIT shares) to non-US person.
  - ◆ Buyer must maintain REIT status through end of REIT's taxable year for year of sale – and indemnify non-US seller if it fails to do so – given no FIRPTA exception for sales of domestically controlled non-REIT USRPHCs.

# Deal Issues – US Partner/Seller

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- ◆ May or may not benefit from REIT structure
- ◆ Possibility of haircut on exit if sell REIT shares (or partnership owning REIT shares)
- ◆ Restrictions on transfer of its interest
- ◆ Costs of establishing and maintaining the REIT structure and executing the domestically controlled REIT strategy

# Deal Issues – “Typical” Joint Venture Matters

## ◆ Contributing appreciated property

- ◆ Tax-deferral
- ◆ Allocation of built-in gain

## ◆ Buy-sell provisions

- ◆ Can both partners be “buyers” without affecting REIT qualification
- ◆ Basis – if no step-up for the buying partner that is buying REIT shares
  - ◆ Impact on REIT distribution requirements

## ◆ Forced sale and drag and tag rights

- ◆ Impact of REIT shares sale
  - ◆ Limiting buyers
  - ◆ Valuation / pricing

## ◆ Governance issues

- ◆ REITs must be managed by directors or trustees

# Deal Issues – Buyer Issues

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- ◆ Confirming REIT status of target REIT
- ◆ Withholding issues
- ◆ Costs of liquidating the target REIT to get stepped-up basis



# Deal Issues – Buyer Step-Up Strategy

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- ◆ Properly and carefully structured, a Buyer post-closing can undertake a section 331 liquidation, e.g., into a partnership purchaser that results in a tax basis step up in the assets. Buyers has no outside gain, and liquidating REIT's inside gain offset with dividends-paid deduction.
  - ◆ The net impact to Buyer is akin to elections under section 336(e), 338, and 754
  - ◆ Buyers are increasingly comfortable and accommodating of this M&A structure
  - ◆ Structuring issue on how to handle “blocker” C corporations inserted into the structure to push the REIT across the domestically controlled threshold

Will Buyer pay the tax on the inside gain of these C corporations?

Will Buyer “downstream” merge the C corporations in tax-free reorganizations?

- ◆ Buyer's section 331 liquidation for a basis step up may be delayed or difficult, if:
  - ◆ Target REIT was a “personal holding company” in Seller's hands
  - ◆ Buyers is a fund/partnership with foreign investors that would have FIRPTA exposure
  - ◆ Seller contractually insists on a delayed liquidation in order to maximally protect from FIRPTA taint any pre-closing dividend distributions to Seller from the target REIT.

# Take-aways

- ◆ Structuring a REIT Joint Venture with a non-US partner means weighing access to capital against additional operational complexity, structure and potential friction costs on exit.
- ◆ Tax will play a key role in identifying costs associated with the operations, structure and exit strategy so that those costs can be allocated in the deal; up-front planning is key.
  - ✓ Number of entities
  - ✓ Funding, distributions and intercompany agreements
  - ✓ REIT qualification, procedures and documentation
  - ✓ Domestically controlled compliance and documentation
  - ✓ Indemnifications and warranties

# Understanding the Unique Tax Rules Applicable to Foreign Governments

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# Sovereign Wealth Funds

## ◆ Overview

### ◆ Sovereign wealth funds (“SWFs”)

- ◆ Government investment vehicles funded by foreign exchange assets and managed separately from official reserves
- ◆ Rapidly growing in number and size
- ◆ Roughly 50 countries have SWFs
- ◆ The Sovereign Wealth Fund Institute estimates the top 25 SWFs have aggregate investments of USD 6 trillion ([www.swfinstitute.org/fund/rankings](http://www.swfinstitute.org/fund/rankings))

# Sovereign Wealth Funds

## ◆ Overview

- ◆ Commodity SWFs – funded by commodity exports that are either owned or taxed by the government
- ◆ Non-commodity SWFs – typically funded through transfers of assets from official foreign exchange reserves
  - ◆ The excess reserves generally result from large balance-of-payment surpluses
  - ◆ The “excess” reserves are transferred to investment funds that can be managed for higher returns

# Sovereign Wealth Funds

## ◆ Other sovereign investors

- ◆ International reserves – external assets that are controlled by and readily available to finance ministries and central banks for direct financing of international payments
- ◆ Public pension funds – investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens
- ◆ State owned enterprises – companies over which the state has significant control through full, majority or significant minority ownership

# Sovereign Wealth Funds

## ◆ IRC Section 892 investors

### ◆ Foreign government

- ◆ Integral part
- ◆ Controlled entity

### ◆ May include:

- ◆ SWF
- ◆ Public pension funds
- ◆ International reserves

### ◆ Does not include:

- ◆ State owned enterprises

# Sovereign Wealth Funds

## ◆ IRC Section 892 exemption

- ◆ Exempt income generally includes income from securities
  - ◆ Stocks, bonds, loans, but not interests in partnerships
- ◆ Income derived by or from controlled commercial entities is not exempt



# Sovereign Wealth Funds

## ◆ Controlled commercial entity

- ◆ An entity (broadly defined) that engages in commercial activities where the foreign government (controlled entity or integral part):
  - ◆ Holds, directly or indirectly, a 50% or more (by vote or value) of the interests in the entity, or
  - ◆ Holds interests that provide the foreign government with “effective practical control”

# Sovereign Wealth Funds

## ◆ Effective practical control

- ◆ A sufficient interest by value or voting power or any other interest that provides the foreign government with effective practical control of the entity
- ◆ Can be achieved through a minority interest that is sufficiently large to achieve effective control, or through the combination of an equity interest and a creditor, contractual or regulatory relationship
- ◆ A foreign government may have effective practical control if it owns a small minority interest in an entity but is also a substantial creditor or is in control of a strategic natural resource used by the entity in its business
- ◆ Veto or blocking rights on specific decisions/actions must be carefully evaluated.

## Capital Gain Dividends and Other Section 897(h)(1) Distributions

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## Section 897(h)(1) Distributions

- ◆ Any distribution by a qualified investment entity (REIT or RIC) to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges of United States real property interests, be treated as gain recognized by such nonresident alien individual, a foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest

# Section 897(h)(1) Distributions

- ◆ Notice 2007-55 clarifies that “any distribution” includes both current and liquidating distributions, notwithstanding section 331 which treats liquidating distributions as payments in exchange for stock
- ◆ What does “attributable to” mean in the context of section 302 or other non-pro rata distributions?
- ◆ “Attributable to” issues:
  - ◆ Netting of gains and losses from sale of USRPIs during the tax year
  - ◆ Netting prior year losses from the sale of USRPIs against current year gains
  - ◆ Netting current year operating losses against gain from the sale of USRPIs
  - ◆ Netting of net operating losses from prior years
- ◆ When is a current or liquidating REIT distribution “**attributable to**” gain from sales or exchanges of USRPIs?
  - ◆ Regulations and pronouncements of the Treasury and the Service do not prescribe a methodology
  - ◆ Analogies to other Code provisions?
  - ◆ NYSBA Tax Section Report on Notice 2007-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6), 7 January 2014
- ◆ Backed up by wash sale anti-abuse rule under section 897(h)(5)

# Section 897(h)(1) Distributions

- ◆ Withholding on section 897(h)(1) distributions
  - ◆ Section 1445(e)(6) – 35% withholding
  - ◆ Treas. Reg. § 1.1445-8 – withholding required on largest amount that could have been declared as a REIT capital gain dividend, whether actually declared or not
    - ◆ Both broader and narrower than substantive tax liability under sections 897(h), 871(b) and 882

## Other FIRPTA/Inbound Issues

# Treatment of Distressed Debt Under FIRPTA

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# Treatment of Distressed Debt Under FIRPTA

- ◆ Is a deeply discounted loan that can only have a value in excess of its purchase price if the underlying value of the real estate securing the loan appreciates a USRPI under FIRPTA?
- ◆ USRPI includes an interest in United States real property other than an interest solely as a creditor
- ◆ An interest other than an interest solely as a creditor includes a loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person. Such interest is in its entirety an interest in real property other than solely as a creditor (Treas. Reg. section 1.897-1(d)(2)(i)).

# Treatment of Distressed Debt Under FIRPTA

## (cont'd)

### ◆ Repossession and foreclosure rights

- ◆ A right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property (Treas. Reg. § 1.897-1(d)(2)(ii)(C)).
- ◆ Thus, no such right will of itself cause an interest in real property which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor (*emphasis added*).

## Fund/AIV Investments

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# AIV Options in Fund Investments

- ◆ Typically, real estate funds offer investments through a “main fund” or through one or more “alternative investment vehicles”
  - ◆ AIVs may exist for tax-exempt or for non-US investors
    - ◆ REITs may be used as blockers for one or both of these investor classes
  - ◆ Crossed or partially blended economics between the main fund and AIVs may create ECI, UBTI or REIT qualification issues
    - ◆ Issues for investors
    - ◆ Issues for sponsor (withholding obligations)